THE GREAT INTERRUPTION

KEY TAKEAWAYS FROM PICTON MAHONEY ASSET MANAGEMENT MARKET VOLATILITY CONFERENCE CALL

March 13, 2020 4:15pm ET

On March 12, we held a special conference call with our portfolio managers addressing market volatility. These are the key takeaways from the call.

OVERVIEW

1. The United States have finally woken up to the issue and are responding to the virus instead of ignoring it (**first positive**)
2. It is a top priority to keep markets properly functioning and the U.S. Federal Reserve ("the Fed") has taken actions in a big way already with more potential moves if necessary (**second positive**)
3. Financial markets now understand there is a recession (**third positive**)
4. We are now waiting for policy makers to announce large fiscal plans to deal with the interim
5. If this response is strong enough and allows households and businesses to remain afloat as much as possible, we see great opportunity here in risk assets.

DAVID PICTON, PRESIDENT, CEO, PORTFOLIO MANAGER

Recap of what we know:

- Financial markets were complacent and feeling like the final bubble stage of the cycle was underway
- This was aided by low interest rates and three major headwinds from last year that were becoming tailwinds before the virus struck:
  - The Fed tightening to easing
  - China deleveraging to easing
  - Trade tensions abating
- Leading indicator data was beginning to improve
- This has been **greatly** interrupted by the virus as the measures to deal with it (social distancing for one) stops all this in its tracks and causes what **looks like** a recession or at least a great big hole in the economy
- Economic data over the next couple months will basically fall off a cliff

Recession:

- There is a big difference between this recession and the last one. This is not a traditional economic slowdown where the endpoint is illusive.
- This ***Great Interruption*** will be significantly better for many consumers in terms of starting points because:
  - Savings rates started at a much higher level
  - One of biggest mortgage refinancing booms in history
  - More rate cuts are on the way
  - President Trump is now facing likelihood of being defeated. We believe that he won't go down without trying. So, we expect big fiscal stimulus boosts as he begins to understand the problem.

Risks:

- Fiscal measures must allow for:
  - U.S. citizens to get affordable testing and treatment regardless of coverage

  - Affected industries must get some support through this social distancing phase
  - Credit market must continue to function, and banks must lend
  - On this, measures are being taken by policy makers

Our take on the markets:

- Valuations vs longer-term interest rates have improved materially
- Sentiment is now closer to max fear mode than max bullish mode a month ago
- What we're doing in our portfolios:
  - Beginning to think about taking on more risk
    - Either equity risk if the mandate allows or adding to high conviction positions
    - Looking to capture upside bounce by using the spike in volatility to structure low-cost call spread trades

JEFF BRADACS, CFA, PORTFOLIO MANAGER, CANADIAN EQUITIES

Canadian Equities:

- In summary, with respect to the sell-off in the Canadian equity market it has come in the following phases:
  - Sell everything Asia-related as companies with exposure to Asia hit hardest
  - Sell anything travel or leisure related
  - Sell energy on fall of OPEC+
  - "Get me out" wave (sell-off winners). This is not a comfortable period but historically this is a sign of capitulation and a bottoming process. This provides us an opportunity to add risk and to our high conviction names.

Energy:

- Currently, a significant number of Exploration & Production companies (E&P) are down over 75% and are pricing in bankruptcy.
- These companies are now cheap options on the potential price recovery of oil.
- Opportunities in energy:
  - Our preference is gas-weighted E&P over oil. Both have sold off materially. As shale oil rigs in the Permian and other areas are dropped, there will be a fall of associated gas that will tighten and strengthen the market for gas pricing

Canadian Banks:

- Canadian banks have weathered past credit crisis before and withstand the losses and still been profitable.
  - One difference this time is we are under a new accounting regime (IFRS)
  - This will result in a pull forward of losses, so expect the next quarter or two to be the worse of the credit losses
- Major Canadian banks have strong capital ratios to weather this storm
  - One area of concern would be regional banks given they are starting with lower capital ratios, have concentrated loan books, and are more exposed to Net Interest Income that will be negatively impacted by BoC rate cuts.
  - Large diversified banks are more favorably positioned given high capital ratios, diversified loan books, low cost deposits.
- In our portfolio we started sell off net short Canadian banks, covering positions in large diversified banks as they approach crisis level valuations.

CRAIG CHILTON, CFA, PORTFOLIO MANAGER, MERGER ARBITRAGE
TOM SAVAGE, CFA, PORTFOLIO MANAGER, MERGER ARBITRAGE

Merger Arbitrage:

- Clearly the unprecedented speed of this selloff has led to incredible volatility. Also, an unprecedented widening of deal spreads. This is especially notable because we haven't had a deal break.
- The real factor right now is risk aversion. Today it felt like capitulation. What's happening is its leading people to believe that the actual probabilities of deal breaking are higher. While it's understandable from a risk aversion standpoint history would not support that as a conclusion.
- Keep in mind that these are definitive merger agreements that have been heavily lowered and negotiated. It's extremely difficult for buyers to terminate them. In fact, many of the agreements have very specific carve outs for using something such as a pandemic to qualify as a material adverse event. We've also had in the past attempts to terminate deals adjudicated in courts.
- With all of that said we still see deals getting announced. Maybe that's surprising to some but on Monday we had Aon buying Willis Towers. That was a $25 billion insurance broker deal. We have buyers, even really stressed buyers like Cineworld, reiterating their commitment today to be going through with their purchase. We don't have any, as I said, specific breaks but there's obviously a lot of nervousness.
- As far as positioning, we came into this crisis having de-risked a little bit in February.
- We are sitting at a position of some of the lowest exposures we've had in recent memory.

SAM ACTON, CFA, PORTFOLIO MANAGER, FIXED INCOME
ASHLEY KAY, STRATEGIST, FIXED INCOME

Credit Market:

- Since Feb 19th, 2020 US High Yield Index Spreads have gone from 375 to over 725 – levels last seen in 2016 and 2011.
- Similarly, US BBB Index Spreads have gone from 130 to 250.
- There have been 3 phases to this sell off:
  - Phase 1 – fears around Coronavirus – hitting airlines, casinos, hotels, china sensitive
  - Phase 2 – energy on March 9th – High Yield energy index down 30% YTD – makes up 15% of BBB and 11% of High Yield
  - Phase 3 – currently in it – figuring out degree to which there is contagion risk to broader credit markets via industry outflows, levered funds blowing up, forced selling, etc.

Our positioning through this period:

- In January we were cautious on credit due to expensiveness, so we had meaningful shorts and hedges in place, to match our negative outlook for energy producers.
- But as the market started to get concerned about the virus, we thought that credit was lagging the equity move lower – mostly because corporate bonds were being held up by the drop in govt rates – i.e. credit spreads were widening, but the price/yield on the bonds weren't actually changing much so we remained very cautious on credit and raised even more cash.
- Then when the OPEC deal collapsed, we got very worried about credit given the large energy weights and the potential for mass downgrades and bankruptcies.
- There are lots of issues to be concerned about in credit markets that we are monitoring closely, but down at these levels, at these wider spreads, as we start to see a policy response from central banks and governments – we are starting to see some real value emerge in non-energy, high quality credit so we are starting to think about positioning for the eventual recovery.

Summary and our outlook:

- Credit has moved a lot in the last three weeks, and we are starting to see value emerge, starting to put some of our large cash balance to work recognizing we may not be fully out of the woods yet and there will be continued volatility.
- Remain negative on the energy sector, expect to see more pain in energy credit as downgrades and bankruptcies accelerate.
- Focused on capital preservation through this period, our hedges and shorts have really kicked in, we expect some of our core longs to experience some mark to market noise as we go through this volatility but we are focused on high grading the portfolio through this period – volatility shakes good bonds out of weak hands and this is when we love to put capital to work.

MICHAEL WHITE

Multi-Strategy:

- Within our multi-strategy offerings, the first two weeks of this selloff had been really perfectly on playbook. We were adding a lot of value and seeing significantly differentiated despite the selloff.
- This past week however has seemed to be a bit more of a regime change. This has a little bit more of systemic feel to this, a GFC (Global Financial Crisis) type risk in the market, where selling is indiscriminate, it's a grossing down feel. When an entire asset class drops 25% in a day you get that ripple effect, the contagion into credit spreads, other asset classes that we use to redistribute equity risk.
- This is part of our study, this is part of our research, that history of indiscriminate selloffs is intense but often very short lived.
- We also like to say that hedges aren't hedges unless they're in place before the event. It's tough to hedge right now. Volatility being where it is creates little opportunity to hedge downside risk because it's expensive to do so. Dave alluded to some opportunities to monetize that volatility with spread trades. We're doing this at the margin.
- We've been tactically positioned to support our negative outlook in energy as well.

"I think you have to take on more risk as a whole, whether it's through the rebalance phase or just outright spending some cash into this marketplace. I think it's time to do that."

"Obviously each of our mandates sticks to its discipline, so we're not going to just gross them up and make a massive bet. But there are ways that you can sneak upside exposure into portfolios without taking on too much overall risk. A lot of it revolves around using the huge spike in volatility to try and get some of that."

DAVID PICTON

We are committed to providing timely updates to our partners and clients. For more information please reach out to your sales representative.

Thank you.